No. 21037

IN THE

United States Court of Appeals For the Ninth Circuit

UNIVERSITY PROPERTIES, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

REPLY BRIEF OF PETITIONER

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SUMMARY OF ARGUMENT

As shown by the record herein and as discussed in Petitioner's Opening Brief, substantial evidence was presented to the Tax Court supporting petitioner's contention that the payments in question were deductible in full as current rentals.

Petitioner amplifies herein its argument that the mutual treatment by petitioner and its lessor of the payments in question as current rentals in their respective books of account constitute substantial, if not compelling, evidence of their character as current rentals, by citing

additional authority regarding the evidential weight of such book entries.

Respondent's brief, while citing numerous cases, fails to supply a legal basis for the Tax Court's decision. Nor does respondent point to any competent evidence in the record to support the findings and decision of the Tax Court. Mere speculation or conjecture by the respondent, and by the Tax Court, do no furnish a basis for affirming respondent's determination of a deficiency in petitioner's income tax.

ARGUMENT

A. The book entries of petitioner and its lessor are entitled to great weight in determining the character of the payments as current rentals.

The issue raised by the respondent's determination of a deficiency in petitioner's income taxes for the years here in question and presented to this court on appeal relates to the characterization of payments made by petitioner as either rentals, capital expenditures, or advance rentals. The basis for the respondent's disallowance of the deductions claimed by petitioner was that "such amount did not represent a current rental payment but a capital expenditure or advance rental not deductible in the year paid." (R. 9, 10)

Respondent asserts that "the present case is concerned with the time for taking deductions." (Br. 14) and states "The taxpayer paid to the University of Washington in each of the fiscal years ended October 31, 1961 and October 31, 1962, the sum of $80,000 *payable for those years* under the supplemental lease agreement of February 5,

1958." (Emphasis supplied) (Br. 9) Petitioner heartily concurs in these statements and urges reversal of the Tax Court's decision for the reason that there is no substantial evidence in the record to refute them.

Petitioner supports its contention that the payments were current rentals by reference to the supplemental lease agreement (Jt. Ex. 4-D) and the fact that both petitioner and its lessor treated the payments on their respective books of account as current rentals. (R.-22) Petitioner's Opening Brief, pages 10-14, presents the basis for petitioner's claimed deductions of payments as current rentals.

Petitioner's reliance on the mutual construction by petitioner and its lessor of the payments in question as current rentals, as reflected by the book entries of the respective parties, is supported by the following authorities.

In *Sam E. Wilson, Jr.*, 20 T. C. 505, 509 (1953, rev'd on appeal on other issues, 219 F.2d 126) the court stated:

> "Book entries are presumed to be correct unless sufficient evidence is adduced to overcome the presumption."

And it was stated in *Stout v. Commissioner*, 273 F.2d 345, 351 (4th Cir. 1959):

> "Book entries are not necessarily conclusive proof of the facts they represent. When made substantially contemporaneously with the events used long before any tax controversy arises, as these were, they are entitled to great weight. When the conduct of the parties is shown to be consistent with the book entries, there is no justifiable basis for findings in conflict with their disclosure. At least a contrary finding, on this record, cannot be said to rest upon substantial evidence."

In *Gordon v. Commissioner,* 268 F.2d 105 (3rd Cir. 1959), it was determined that in finding contrary to the record entries in the taxpayer's and its supplier's books, "* * * the Tax Court arbitrarily disregarded unchallenged, competent and relevant evidence in the record which was inherently credible." (page 107); and that "* * * the reasons given by the Tax Court for rejecting the uncontroverted evidence of the book entries are wholly without substance." (page 109)

Here also, the book entries of petitioner and its lessor (R.-22), which were consistent with each other and with the parties' agreement (supplemental lease agreement, Jt. Ex. 4-D), treated the payments as rentals accruing in the tax years here involved. The Tax Court relied on no substantial evidence to the contrary and its decision must therefore be reversed.

B. The "presumption of correctness" of the Commissioner's determination was dispelled.

Since the petitioner presented evidence of the characterization of the payments in question as current rentals, any presumption of correctness of the Commissioner's determination otherwise operable disappeared. As was stated by this court in *Clark v. Commissioner,* 266 F.2d 698, 706 (9th Cir. 1959)

> "If the taxpayer introduces evidence from which the determination of the Commissioner contained in a deficiency notice could be found inaccurate then the presumption disappears."

In *Stout v. Commissioner, supra,* the court stated:

> "The presumption of correctness is procedural. It transfers to the taxpayer the burden of going for-

ward with the evidence, but it disappears in a proceeding to review for assessment when substantial evidence contrary to the Commissioner's finding is introduced. Thereafter, the Tax Court, in such a proceeding, must make its own findings based upon the evidence before it, and we may affirm *only if the findings of the Tax Court are supported by substantial evidence in the record of that proceeding.*" (Emhasis supplied) page 350.

There is no evidence in the record of the Tax Court proceeding, however, that would support a finding that petitioner's payments were advance rents or capital expenditures. As pointed out in petitioner's Opening Brief, the Tax Court's reasons for denying petitioner's deductions were premised upon erroneous factual inferences and on erroneous conceptions of the law relating thereto. (Br. 14-17) As there is no substantial evidence in the record supporting the Tax Court's findings, its decision, therefore, cannot be affirmed.

C. Respondent's cases relating to presumption of correctness and burden of proof are inapplicable.

Respondent cites, without discussion, numerous cases at pages 13 and 14 of its brief relative to the presumption of correctness of the Commissioner's findings and to the burden of proof in a Tax Court proceeding. The cases cited, however, bear no factual similarity to the instant case. It is submitted that the law relative to the above issues is as set forth in the cases discussed in the preceding section of this brief.

D. Cases cited by respondent relative to the time for taking deductions are distinguishable.

At pages 14 and 15 respondent cites numerous cases for the general proposition that a taxpayer cannot deduct

expenses from a given year's income which are attributable to income earned in other years. Again, these cases are cited without discussion in respondent's brief. The proposition stated has validity with respect to the instant case only if the facts here show that the payments in question were attributable to other years. The cases cited by respondent are, without exception, so factually dissimilar from the present case as to supply no authority for the Tax Court's disallowance of the deductions herein claimed. Respondent apparently accorded the case of *Lichtenberger-Ferguson Co. v. Welch*, 54 F.2d 570 (Resp. Br. 15, 19) sufficient weight to have cited it twice in his brief. That case involved a claimed deduction for an advertising expense contracted for in the year prior to the one in which the advertising services were to be rendered. Both the actual payment of the expense and the receipt of the services occurred in a tax year subsequent to the one in which the taxpayer claimed its deduction. In the present case, the additional rentals were paid in the years in which the consideration for the payment was received.

E. Cases cited by respondent for the proposition that the payments here in question were not current rentals do not support that proposition.

The cases cited by respondent at pages 15 to 22 of its brief, few of which were discussed, do not support the decision of the Tax Court in the instant case. To discuss and distinguish each case individually would be an unduly burdensome task and would unnecessarily lengthen this brief, in light of the patent irrelevancy of the great majority of such cases. Briefly, the great majority of the cases cited are distinguishable upon one or more of the

following facts, none of which are present in the instant case.

1. Cases involving close relationship between lessor and lessee, with consequent finding that payments were excessive or not required: *Utter-McKinley Mortuaries v. Commissioner,* 225 F.2d 870 (Resp. Br. 15, 16, 19); *LeMoyne v. Commissioner,* 47 F.2d 539 (Resp. Br. 16); *Limmericks, Inc. v. Commissioner,* 165 F.2d 483 (Resp. Br. 16); *W. H. Armston Co. v. Commissioner,* 188 F.2d 531 (Resp. Br. 16); *White v. Fitzpatrick,* 193 F.2d 398 (Resp. Br. 16); *Wade Motor Co. v. Commissioner,* 241 F.2d 712, 26 T.C. 237 (Resp. Br. 16); *Midland Ford Tractor Co. v. Commissioner,* 277 F.2d 11 (Resp. Br. 16); *Potter Electric & Signal Manufacturing Co., v. Commissioner,* 286 F.2d 200 (Resp. Br. 16); *Fairmont Park Raceway, Inc. v. Commissioner,* 327 F.2d 780 (Resp. Br. 16); *Van Zandt v. Commissioner,* 341 F.2d 440 (Resp. Br. 16).

2. Cases in which the "lessee" acquired an equity in the "leased" property: *Osterreich v. Commissioner,* 226 F.2d 798 (Resp. Br. 15, 19) *Bues v. Commissioner,* 261 F.2d 176 (Resp. Br. 16).

3. Cases involving payments specifically designated by the parties for application to a non-rental account: *West Virginia Northern Railway Co. v Commissioner,* 283 F.2d 63 (Resp. Br. 16); *King Amusement Co. v. Commissioner,* 44 F.2d 709 (Resp. Br. 18); *Saks & Co. v. Commissioner,* 20 BTA 1151 (Resp. Br. 19); *H. Feindrich, Inc. v. Commissioner,* 3 BTA 77 (Resp. Br. 19).

4. Cases involving payments required in first years of

lease term which were grossly disproportionate to those required in other years of the term: *Galatoire Bros. v. Lines,* 23 F.2d 676, affirming 11 F.2d 878 (Resp. Br. 16, 19); *Baton Coal Co. v. Commissioner,* 51 F.2d 469 (Resp. Br. 19, 20); *Main & McKinney Building Co. v. Commissioner,* 113 F.2d 81 (Resp. Br. 19, 20); *Southwestern Hotel Co. v. United States,* 115 F.2d 686 (Resp. Br. 19, 21, 22) *Fitzsimmons v. Commissioner,* 37 T.C. 179 (Resp. Br. 19).

The following cases cited by the respondent are also distinguishable on the facts, and therefore do not constitute authority for the Tax Court's determination in the instant case. *J. Allend & Bros., Inc. v. Commissioner,* cited at pages 17 and 18 of respondent's brief, is clearly distinguishable from the instant case for the reason that a deduction was there sought for payment made in a year in which the taxpayer-lessee had no possession or right to possession of the premises.

In *Home Trust Company v. Commissioner,* 65 F.2d 532 (Resp. Br. 19) there was no contention that the payment in question, made to purchase the interest in a 20-year sub-lease of property of which the taxpayer had become principal lessee under a 99 year lease, was rental. The payment was conceded to be the cost of the acquisition of the sub-lease. There was no question as to the characterization of the payment as current rental.

The issue considered in *Wolan v. Commissioner,* 184 F.2d 101 (Resp. Br. 19) (whether an unamortized portion of advance rentals on the books of a liquidated corporate lessee could be deducted in full by the purchaser of the former lessee's assets in the year of such purchase) bears

no relation whatever to the issues, legal or factual, in the case at bar and for that reason may be disregarded. *Cooper Foundation v. O'Malley,* 221 F.2d 279 (Resp. Br. 19), is likewise distinguishable.

Bloedel's Jewelry, Inc., 2 BTA 611, (Resp. Br. 19), is similar on its facts to *J. Alland & Bros., Inc. v. Commissioner, supra,* in that the question presented was whether monies paid in a tax year prior to the year in which the lessee was entitled to possession of the premises could be deducted in the year of payment. The case of *Williamson v. Commissioner,* 37 T. C. 941 (Resp. Br. 19) is distinguishable for the same reason.

In *Jos. J. Neel Co. v. Commissioner,* 22 T.C. 1083 (Resp. Br. 19) the issue presented was not whether the deduction there sought was a rental payment, but whether the obligation owed by the lessee, which was admittedly an acquisition cost and not a rental obligation, was ratably deductible over the term of the lease. The Commissioner had contended that the obligation was not so deductible, alleging that the obligation to pay was contingent. Thus, neither the facts nor the legal issues there considered bear any relation whatever to the instant case.

F. There is no substantial evidence in the record to support the Tax Court's decision.

Respondent's discussion commencing at page 23 of its brief does not fill the void evidenced by his failure to cite cases of significant factual or legal relevancy. Petitioner's argument for the deductibility of the payments as current rentals is supported not only by provision 2 of the supplemental lease agreement, quoted at page 23 of respondent's brief, but also by the clause of the supple-

mental lease agreement (quoted and discussed in petitioner's Opening Brief at page 12) which clearly and unequivocally states the consideration for the inclusion of the premises added to petitioner's leasehold. The supplemental lease agreement as written and construed by the parties not only negatives the respondent's contention that the payments in question constituted consideration for the inclusion of the post office parcel, but affirmatively establishes that the payments were in fact paid and received as current rentals. It is thus incumbent upon respondent to point to substantial evidence in the record that controverts the evidence supplied by petitioner (see discussion *supra*, pp. 4, 5) Respondent must point to substantial evidence in the record that establishes the payments in question as advance rentals or capital expenditures.

Respondent can cite no evidence whatever to dispel the characterization of the payments as current rentals. Respondent apparently asserts at page 29 of its brief, that the "preliminary recitals" of the supplemental lease agreement, though indicating the scope and purpose of the agreement (which "preliminary recitals" presumably include the statement regarding petitioner's assumption of its lessor's obligation to the United States government to demolish the old Post Office Building and construct a new Post Office Building) were not "substantive" and not expressive of the consideration supplied for the inclusion of the increment to petitioner's leasehold estate. It is naive to suggest that the assumption of this substantial obligation does not constitute contractual consideration. Prior to the execution of the supplemental lease agreement, the petitioner was under no duty to perform its les-

sor's obligations under the agreement with the United States government. The sole responsibility retained by the University of Washington in respect to its agreement with the United States government was to supply funds, to the extent of the $870,000, for the demolition and construction of the new Post Office building. The petitioner was required to pay the cost in excess of $870,000 relating to the said demolition and construction. (Jt. Ex. 4-D, p. 3) It is elementary contract law that the creation of petitioner's contingent liability to pay an amount in excess of the $870,000 would be sufficient consideration for the inclusion of the additional leasehold estate. Moreover, the substantial duties connected with the supervision of the project assumed by petitioner, in addition to the assumption of myriad of other responsibilities, supplied ample consideration.

As a basic premise, it may be stated that a lessor and lessee may agree to a modification of the rents called for under a lease and such modification will not, as a necessary result, require characterization of the modified payments as something other than current rentals. It is only when the modified payments are demonstrably characterizable as something other than payments for current use or occupation of the demised property that capitalization of the modified payments will be required. Circumstances which may lead to such a result, in the absence of contrary evidence, are: the requirement of a grossly disproportionate payment during the first years of a term as compared with payments due in subsequent years; a close relationship between the parties, usually by reason of family or ownership ties; evidence that the "lessee" is in fact acquiring an equity in the property "leased"; or,

a specific agreement by the parties that the payments are to be applied to non-rental accounts. (See cases cited at pages 7-9, *supra*).

Respondent does not contend that the payments here were grossly disproportionate. As indicated by respondent's notice of deficiency, the issue presented is the characterization of the payments as current rental (as contended by petitioner), or advance rentals or acquisition costs (as contended by respondent). (R. 9, 10) There is no suggestion that the payments were excessive, unreasonable, or that the parties here were in collusion to avoid the payment of an income tax. Certainly the parties did not designate the payments as being for something other than current rentals, and it is conceded by the respondent that the petitioner had not taken and was not taking title to and had no equity in any of the property under the lease. (Resp. Br. 10)

Respondent's statement (Br. 24) that the treatment by petitioner and its lessor of the payments on its books and in petitioner's tax returns as current rentals is not determinative of their purpose or character is contrary to the law. See *Stout v. Commissioner; Gorden v. Commissioner* and *Sam E. Wilson, Jr., supra.* Respondent reasons that if such treatment was determinative of the characterization of the payments, the Commissioner would be precluded from questioning the correctness of the taxpayer's returns. (Br. 24) While the treatment is determinative if no contrary evidence is adduced by the Commissioner, the Commissioner is not precluded from adducing such evidence. The Commissioner's problem in the instant case is that he has adduced no evidence to support a contrary determination.

In an apparent attempt to dilute the force of the harmonious treatment of the payments by the petitioner and its lessor, respondent cites authority for the proposition that, as a matter of *tax accounting*, payments, even in the nature of advance rental, may be treated as current income in the hands of the lessor. (Br. 24) The falacy in this reasoning is that the petitioner's lessor is a tax exempt organization and is therefore not required to account pursuant to a fiction created by reason of tax law.

At pages 30-32 of its brief, the respondent alludes to the alleged absence of an explanation for the payments in question and the timing thereof. Hypothetical "reasons" are therein conjured up by the respondent in an attempt to characterize the payments as consideration for the inclusion of the increment to petitioner's leasehold. These "reasons", however, are nothing more than hypothetical possibilities, unsupported by any evidence in the record and, therefore, entitled to no weight whatever.

Respondent at page 31, further faults petitioner for an alleged failure to explain the reasonableness of the payments as additional rentals for the years of payment, or to explain how the additional rentals could be justified as rental expense for the years in question. But the Commissioner's notice of deficiency, and therefore the issues presented in this case, did not include a reference to the "unreasonableness" of the payments in question and this issue is therefore inappropriate and outside the scope of this review. Moreover, in view of the fact that during the years in question petitioner paid nearly two million dollars annually to its lessor as rental (R. 9, 10), the contention that an additional $80,000 per year should be considered "unreasonable" borders on the absurd. See discus-

sion at pages 20 and 21 of petitioner's Opening Brief. Additionally, the cases cited under point 4, pages 7, 8 *supra*, indicate, by negative implication, that in order for a payment otherwise designated as rental to be construed as an advance rental or capital expenditure the payment must be grossly disproportionate to those required during the remainder of the lease term.

Respondent speculates that the Univeristy of Washington would seem justified in demanding "some return for the remainder of the lease period over and above the rentals provided in the original lease agreement." (Br. 32) The answer to this speculation is that the Lease Agreement (Jt. Ex. 3-C, p. 4) provided for payment by petitioner to its lessor of percentage rents, and this provision was adopted by the Supplemental Lease Agreement. (Jt. Ex. 4-D, p. 3) Thus, the parties to said agreement contemplated substantial returns to the lessor over the remaining years of the lease term.

Finally, it is notable that the respondent has failed to make a significant response to petitioner's alternative contention set forth at pages 24-31 of its Opening Brief, that the payments in question were deductible as ordinary and necessary business expense, regardless of their characterization as rentals or non-rentals. The most respondent can muster in response to petitioner's alternative contention is a rather lame repetition of the statements made in respect thereto by the Tax Court, without discussion of the facts or law set forth in petitioner's Opening Brief.

CONCLUSION

Respondent's brief, despite voluminous, excessive and often irrelevant citations of case "authority," totally fails

to answer the issues raised in Petitioner's Opening Brief and to supply a factual or legal basis for the decision of the Tax Court.

In particular, it is evident from the record that petitioner supplied all of the evidence relied upon by the Tax Court, and that such evidence established a *prima facie* case for the deductibility of the payments in question. In the face of such evidence, it was incumbent upon respondent to provide substantial evidence contrary to that adduced by petitioner. Respondent's assumptions and speculations as to the purpose for the payments do not constitute good guesses, much less the substantial evidence required for affirmance of his determination by the Tax Court.

Respondent's failure to present a substantial discussion of petitioner's alternative contention, and his failure to present any discussion of several cases cited by petitioner in its Opening Brief relative thereto, provides strong argument for the deductions claimed by petitioner on that ground.

For the foregoing reasons and for the reasons set forth in Petitioner's Opening Brief, the decision of the Tax Court should be reversed and the payments in question held deductible in full by petitioner.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with these rules.

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